NMA Mixed Use Developments Report 2019 & Cytonn Weekly#45/2019

Equities

Market Performance

During the week, the equities market was on a downward trend with NASI, NSE 20 and NSE 25 declining by 2.0%, 0.6% and 3.0%, respectively, taking their YTD performance to gains/losses of 14.6%, (4.1%) and 11.4%, for NASI, NSE 20 and NSE 25, respectively. The performance in NASI was driven by losses recorded by stocks mainly in the Banking sector with NCBA Group, KCB Group, Barclays Bank of Kenya and Standard Chartered Bank recording losses of 11.7%, 6.3%, 5.9% and 5.8%, respectively.

Equities turnover declined by 18.0% during the week to USD 58.3 mn, from USD 71.1 mn the previous week, taking the YTD turnover to USD 1,300.4 mn. Foreign investors remained net sellers for the week, with a net selling position of USD 6.7 mn, increasing by 41.6% from a net selling position of USD 4.7 mn recorded the previous week.

The market is currently trading at a price to earnings ratio (P/E) of 12.3x, 7.3% below the historical average of 13.3x, and a dividend yield of 6.5%, above the historical average of 3.9%. With the market trading at valuations below the historical average, we believe there is value in the market. The current P/E valuation of 12.3x is 26.9% above the most recent trough valuation of 9.7x experienced in the first week of February 2017, and 48.3% above the previous trough valuation of 8.3x experienced in December 2011. The charts below indicate the historical P/E and dividend yields of the market.

Earnings Releases

National Bank of Kenya released their Q3'2019 financial results

During the week, the National Bank of Kenya released its Q3'2019 financial results. Below is a summary of their performance;

- Profit before tax increased to Kshs. 0.7 bn, from a loss of Kshs 0.1 bn Q3'2018. The bank recorded a 1,753.4% increase in profit after tax to Kshs 0.4 bn from a profit after tax of Kshs. 22.0 mn in Q3'2018. The performance was driven by a 7.3% increase in total operating income, and was weighed down by the 3.9% increase in the total operating expenses,
- Total operating income increased by 7.3% to Kshs. 6.0 bn from Kshs. 5.6 bn in Q3'2018. This was driven by an 11.6 % increase in Net Interest Income (NII) to Kshs. 4.6 bn from Kshs. 4.1 bn in Q3'2018, despite the 4.6% decline in Non-Funded Income (NFI) to Kshs. 1.4 bn from Kshs. 1.5 bn in Q3'2018,
- Interest income increased by 4.7% to Kshs. 6.6 bn, from Kshs. 6.3 bn in Q3'2018, driven by the increase in interest income on Loans & Advances that increased by 6.0% to Kshs. 3.3 bn, from

Kshs. 3.1 bn in Q3’2018. Interest income on Government Securities increased by 4.2% to Kshs. 3.3 bn, from Kshs. 3.2 bn in Q3’2018. As a result, the yield on interest-earning assets increased to 10.6% in Q3’2019 from 10.1% in Q3’2018,

- Interest expense declined by 8.2% to Kshs. 2.0 bn, from Kshs. 2.2 bn in Q3’2018, following a 16.8% decline in the interest expense on Customer Deposits to Kshs. 1.6 bn, from Kshs. 2.0 bn in Q3’2018. Interest expense on Deposits & Placements from Banking Institutions increased by 38.8% to Kshs. 0.3 bn, from Kshs. 0.2 bn in Q3’2018. The cost of funds declined marginally to 2.9%, from 3.0% in Q3’2018, while Net Interest Margin increased to 7.2%, from 6.6% in Q3’2018,
- Non-Funded Income (NFI) declined by 4.6% to Kshs. 1.4 bn, from Kshs. 1.5 bn in Q3’2018. The decline in NFI was driven by a 39.1% decrease in Other Income to Kshs. 0.1 bn, from Kshs. 0.2 bn in Q3’2018, coupled with a 10.3% decline in foreign exchange income to Kshs. 363.4 mn, from Kshs. 404.9 mn in Q3’2018. Fees and commissions on loans and advances also declined by 6.4% to Kshs. 90.0 mn, from Kshs. 96.2 mn in Q3’2018. Other Fees however increased by 5.8% to Kshs 0.9 bn from Kshs 0.8 bn recorded in Q3’2018. The current revenue mix stands at 86:14 funded to non-funded income as compared to 80:20 in Q3’2018. The proportion of funded income to total revenue increased owing to the decline in NFI coupled with the increase in NII,
- Total Operating Expenses increased by 3.9% to Kshs. 5.4 bn, from Kshs. 5.2 bn, largely driven by the 3.7% increase in Staff Costs to Kshs. 3.0 bn in Q3’2019, as compared to Kshs 2.9 bn in Q3’2018. The lower write-back in Loan Loss Provisions of Kshs 30.8 mn compared to Kshs 0.2 bn in Q3’2018, also contributed to the increase in Total Operating Expenses. Other Expenses declined by 4.5% to Kshs. 2.4 bn in Q3’2019, from Kshs. 2.5 bn in Q3’2018,
- The cost to income ratio improved to 88.8% from 91.8% in Q3’2018. Without LLP, the cost to income ratio deteriorated to 87.5%, from 86.7% in Q3’2018, as a result of the lower write-back in Loan Loss Provisions,
- The balance sheet experienced a contraction, as total assets decreased by 4.7% to Kshs. 107.2 bn from Kshs. 112.5 bn in Q3’2018. This decrease was largely caused by a 24.8% decline in cash and bank balances to Kshs 6.9 bn, from Kshs 9.2 bn in Q3’2018, coupled with the 17.5% decline in Government Securities to Kshs 34.1 bn, from Kshs 41.3 bn in Q3’2018,
- The loan book declined marginally by 0.3% to Kshs 47.9 bn, from Kshs 48.0 bn in Q3’2018.
- Total liabilities decreased by 5.3% to Kshs. 99.9 bn, from Kshs. 105.5 bn in Q3’2018, driven by an 11.1% decline in Customer Deposits to Kshs. 82.5 bn, from Kshs 92.8 bn in Q3’2018. However, there was a 24.5% increase in Deposits and Balances due to other banking Institutions to Kshs 7.3 bn, from Kshs 5.8 bn in Q3’2018, and the 48.0% increase in Other Liabilities to Kshs. 10.0 bn, from Kshs. 6.8 bn in Q3’2018,
- Deposits per branch decreased by 9.8% to Kshs. 1.2 bn, from Kshs. 1.3 bn in Q3’2018, as the bank closed the third quarter with 69 branches,
- The slower decline in loans as compared to deposits led to an increase in the loan to deposit ratio to 58.0%, from 51.7% in Q3’2018,
- Gross non-performing loans increased by 6.7% to Kshs. 33.0 bn in Q3’2019, from Kshs. 30.9 bn in Q3’2018. Consequently, the NPL ratio increased marginally to 47.9%, from 47.1% in Q3’2018. General provisions increased by 17.5%, to Kshs. 15.6 bn from Kshs. 13.3 bn in Q3’2018. The NPL coverage thus increased to 63.4% in Q3’2019, from 57.1% in Q3’2018.
- Shareholders’ funds increased by 4.5% to Kshs. 7.3 bn in Q3’2019, from Kshs. 7.0 bn in Q3’2018, aided by the 19.3% increase in the statutory loan loss reserves to Kshs 4.5 bn, from Kshs 3.8 bn in Q3’2018,
- National Bank is currently severely undercapitalized with a core capital to risk-weighted assets ratio of 1.5%, 9.0% below the statutory requirement. In addition, the total capital to risk-weighted assets ratio was 2.9%, below the statutory requirement by 11.6%. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 1.8%, while total capital to risk-weighted assets came in at 3.5%, indicating that the bank’s total capital relative to its risk-weighted assets declined by 0.6% due to implementation of IFRS 9, and,
- National Bank currently has a return on average assets of 0.4% and a return on average equity of

5.5%.

Key Take-Outs:

1. National Bank is currently undercapitalized with the total capital to risk-weighted assets ratio coming in at 2.9%, 11.6% below the 14.5%, as required by regulation. The bank has been granted an exemption to operate below the regulatory requirement but the current acquisition by KCB Group should see the bank become recapitalized as they operate as a separate subsidiary for two years, and,
2. The bank experienced a deterioration in asset quality, with gross non-performing loans (NPLs) increasing by 6.7% to Kshs. 33.0 bn, from Kshs. 30.9 bn in Q3'2018. The NPL ratio of 47.9% is above the banking sector average of 10.0% and thus the bank needs to adopt a raft of measures to improve on the overall asset quality.

For more information, see our National Bank Q3'2019 Earnings Note

Weekly Highlight

During the week, the President signed the Finance Bill 2019 into law, scrapping the law capping interest rates at 4.0% above the Central Bank Rate (CBR). Interest rate caps were introduced in Kenya in September 2016 with the enactment of the Banking (Amendment) Act, 2015, due to the high cost of borrowing that saw banks charge interest rates as high as 21.0% for loans, yet depositors earned approximately 5.0% for their deposits. The main aim of the rate caps was to reduce the cost of borrowing, expand access to credit, and increase the return on savings. However, since its enactment, the rate cap failed to achieve its intended goals evidenced by subdued private sector credit growth and reduced loan accessibility, resulting in the proliferation of alternative credit markets such as loan sharks and mobile financial services. In order to reverse the effects of the rate cap, the President echoed the sentiments of the International Monetary Fund (IMF) and Central Bank of Kenya (CBK) who had called for the repeal of interest rate caps in order to allow credit flow to the economy by enhancing access to credit by the private sector, specifically the Small and Medium Enterprises (SMEs), as well as cutting out exploitative lenders such as unregulated loan sharks and mobile financial services providers. For more information, see our latest topical on the rate caps End of Interest Rate Caps?

With the interest rate cap repealed, we expect increased access to credit by borrowers that have been shunned under the current regulated loan-pricing framework. However, we still recommend that we deal with two key outstanding issues of (i) Consumer Protection Against Abuse by Banks, and (ii) Promoting Competing Alternative Funding Channels.

Universe of Coverage

Below is a summary of our universe of coverage:

Banks	Price at 1/11/2019	Price at 8/11/2019	w/w change	YTD Change	Target Price*	Dividend Yield	Upside/ Downside**	P/TBv Multiple	Recommendation
Sanlam	16.0	17.0	6.3%	(14.8%)	29.0	0.0%	70.6%	**0.7x**	**Buy**
I&M Holdings* **	47.0	50.0	6.4%	5.9%	79.8	7.8%	67.3%	**0.8x**	**Buy**
Diamond Trust Bank	116.0	120.0	3.4%	(27.2%)	175.6	2.2%	48.5%	**0.6x**	**Buy**
Kenya Reinsurance	3.2	3.1	(0.9%)	(17.2%)	3.8	14.3%	33.8%	**0.3x**	**Buy**
KCB Group* **	53.3	49.9	(6.3%)	12.1%	61.4	7.0%	30.0%	**1.3x**	**Buy**

Banks	Price at 1/11/2019	Price at 8/11/2019	w/w change	YTD Change	Target Price*	Dividend Yield	Upside/ Downside**	P/TBv Multiple	Recommendation
Jubilee holdings	360.0	350.3	(2.7%)	(13.5%)	418.5	2.6%	22.1%	**0.9x**	**Buy**
CIC Group	3.0	3.2	6.3%	(20.5%)	3.8	4.0%	21.7%	**1.1x**	**Buy**
Britam	7.0	7.4	6.0%	(30.2%)	8.8	0.0%	18.6%	**0.7x**	**Accumulate**
Liberty Holdings	9.7	10.3	6.2%	(24.7%)	11.3	4.9%	14.6%	**0.7x**	**Accumulate**
NCBA Group	39.5	34.9	(11.7%)	7.7%	37.9	4.3%	13.1%	**0.7x**	**Accumulate**
Equity Group* **	46.5	48.9	5.1%	7.5%	53.0	4.1%	12.6%	**1.9x**	**Accumulate**
Standard Chartered	214.8	202.3	(5.8%)	2.7%	208.0	9.4%	12.2%	**1.6x**	**Accumulate**
Barclays Bank***	13.5	12.7	(5.9%)	0.0%	12.6	8.7%	7.7%	**1.7x**	**Hold**
Co-op Bank***	15.8	15.7	(0.6%)	(16.8%)	15.0	6.4%	1.9%	**1.3x**	**Lighten**
Stanbic Holdings	110.5	110.0	(0.5%)	5.8%	100.5	4.4%	(4.3%)	**1.2x**	**Sell**
HF Group	7.2	7.2	0.0%	27.1%	2.8	0.0%	(61.7%)	**0.3x**	**Sell**

Target Price as per Cytonn Analyst estimates
*****Upside / (Downside) is adjusted for Dividend Yield***
******Banks in which Cytonn and/or its affiliates are invested in***

We are "Positive" on equities for investors as the sustained price declines has seen the market P/E decline to below its historical average. We expect increased market activity, and possibly increased inflows from foreign investors, as they take advantage of the attractive valuations, to support the positive performance.